Joseph Yam: Asian finance

Speech by Mr Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the Swiss National Bank Event, International Centre for Banking and Monetary Studies, Geneva, 9 November 2004.

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Introduction

I am delighted to have been invited to speak here at the International Centre for Banking and Monetary Studies in Geneva. I understand that you have in the past had many lectures from central bankers from Europe and the United States, but no one yet from Asia. I therefore feel particularly honoured to be the first Asian central banker to speak to you. This is timely, since banking and monetary developments in Asia have been receiving increasing international attention, particularly after the Asian financial crisis of 1997-98. I realise, of course, that monetary union in Europe must have been the monetary event of the past decade, in terms of occupying the time of academics and practitioners in the field, particularly in Europe. It has also had a large impact in the financial landscape of other economies, as I am sure the many members of the Swiss financial community that are here today would agree.

But with the successful birth of the euro, I hope we can all devote a little more time to Asia. I am confident that giving greater attention to Asia will turn out to be a most fruitful venture. Indeed, I would argue that such initiatives are now of strategic importance to the future of the global financial system. I very much hope that I can convince you today why this is so. As I shall demonstrate later, the financial significance of Asia is indisputable. Yet, in many parts of Asia, financial intermediation, which is so important to promoting economic growth and development, remains elementary. There is I think an urgent need for Asia to harness its substantial financial resources for promoting growth and development but also for minimising Asia's vulnerability to financial instability. With financial globalisation, the ability of Asia to get this right has significant implications for global finance. I also hope that I can, at the same time, raise your interest in some of the specific monetary and financial issues that we are tackling, in the region as a whole and in individual economies, with a special emphasis on China, including Hong Kong, where I come from.

Asian finance

Let me begin with a description of Asian finance, as I see it. There are six characteristics I would like to draw your attention to. The **first** is the **financial significance** of Asia. As I mentioned earlier, this is phenomenal. It is easy to appreciate this by pointing to some impressive numbers, such as those relating to the amount of foreign reserves held by Asian economies and the amount of portfolio and foreign direct investments going into, or coming out of, Asia. Indeed, there are seven economies holding foreign reserves in excess of US$100 billion and all seven of them are in Asia[1]. Together they hold a total of over US$2 trillion of foreign reserves, which have doubled over the short period of only three years. The sheer size of these foreign reserves and the business opportunities they make available have greatly enhanced the level of sophistication in their management. Increasingly, such management is making use of advanced financial instruments and expert services offered by international investment banks, and is much more alert to shifts in short-term trends in currencies as well as in interest rates.

Private-sector savings in Asia are also very substantial, given the high savings rate, which is generally in double digits and, for some, as high as 30% to 40%. Although the management of private sector savings in Asia is generally a lot less sophisticated by comparison, it is being increasingly institutionalised, along with the introduction of provident funds, and is managed by professionals, becoming increasingly active in the international markets. Over half of the new issues of US Treasury securities are now taken up by Asian economies. And Asia is now a large net exporter of portfolio

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[1] June 2004 figures.

capital. For nine emerging Asian economies (excluding Japan), the amount was a net US$225 billion in 2003.

The **second** characteristic of Asian finance is, by contrast, **the lack of sophistication** in domestic financial intermediation. The effective channelling of savings into investments is crucial for the promotion of economic growth and development. This is something that developed markets with advanced financial systems take for granted. Yet, in a significant part of Asia, notwithstanding its financial clout, a significant part of domestic savings is still put under mattresses. A convenient and effective channel that could be used to absorb these savings, in a manner that commands the confidence of those who save, does not exist. Where some form of financial system exists for facilitating the important process of financial intermediation, it is usually a system that suffers from a preponderance of banks. This lack of diversity in the financial intermediation channels is widespread in Asia; and frustratingly so, particularly for those with responsibility for promoting such diversification, for the sake of efficiency as well as financial stability. The market capitalisation and turnover of domestic debt and equities, in absolute terms as well as relative to GDP, is generally low when compared with corresponding numbers in the developed markets. This is so even in Hong Kong, the pre-eminent international financial centre in the region. The domestic debt market there, in terms of the amount of debt outstanding in the domestic currency, is only about 45% of GDP, although this is partly the result of a long history of fiscal discipline.

The emerging markets of Asia are aware of the important need for financial system development. This brings me to the **third** characteristic, which concerns the development strategies being adopted. Although these vary between different economies, having regard to the domestic circumstances, one underlying strategy common to all is **financial openness**. Financial systems are opened up, for the participation of domestic and foreign financial intermediaries, with a view to obtaining efficiency gains through greater competition and importing financial expertise. This has generally been a success, although specific problems have been encountered. A feature of these problems has been that, at times, the profit motive and the enthusiasm of financial intermediaries, not necessarily just the foreign ones, might prevail to such an extent as to undermine the public interest of ensuring effective financial intermediation. The problems might also have been the result of ineffective regulation of financial markets and supervision of financial intermediaries, and inadequate regard to the basic purpose of the financial system. One example, and it is only appropriate that I should use an example from Hong Kong, is the closure of the Hong Kong stock market in 1987. This was done in the interest of the financial intermediaries who were about to be hit badly by the world-wide crash that occurred overnight because they had taken large and concentrated positions in stock futures. The closure of a secondary market, which provides the liquidity for attracting primary market activity that channels additional savings into investments, was blatantly wrong and seriously damaged the credibility of the stock market as a channel for financial intermediation. The damage was temporary, as it turned out, and confidence was eventually re-established, but not without much soul-searching and many market reform measures.

Such problems notwithstanding, it is clear that emerging markets in Asia are enthusiastic in embracing financial openness. To be sure, such willingness has not been entirely voluntary. Neither has the pace with which openness is being pursued. For relatively small domestic markets, there is understandably a lack of attraction for the large and sophisticated international financial intermediaries. And so there may be special privileges or incentives offered, at the risk of creating structural distortions in the financial system, as enticement for the esteemed presence of the household names of international finance. More important, individual jurisdictions have been, whether of their own free will or under pressure, pursuing financial openness, not just in respect of the financial system, but also in respect of the international mobility of capital. This they do so, in some cases, perhaps prematurely, by reference to their ability to manage the associated risks to monetary and financial stability on a continuous basis, in keeping with the demands arising from the changing scene, and changing risks, of international finance. As a result, the path towards financial openness has not been a smooth one, and diversions, although of a defensive nature, have been rather frequent lately. This is an aspect to which I shall return later.

Let me turn first to how financial openness has been manifested in the **dynamics** of financial intermediation in Asia: this is the **fourth** characteristic of Asian finance that I wish to talk about. High public-sector and private-sector savings, less developed financial systems and financial openness have affected financial intermediation in two ways. First is a relative shift of dependence on foreign savings, as against domestic savings, as a source of funding domestic (fixed and portfolio) investments. Second is reduced availability of such funding, as evidenced by Asia being a net exporter of capital. To be sure, there has correspondingly been more efficient allocation and use of scarce funding on a global basis, made possible by the freer mobility of capital and the freer convertibility of currencies. But there has also been a change in the dynamics of financial intermediation in Asia, in that there is a process of recycling of Asian funds through the developed markets back into Asia that has become quite significant. And not only is it significant, it is also quite potent and demanding.

Whether we like it or not, the behaviour of foreign savings in the hands of foreign financial intermediaries is quite different from that of domestic savings. To start with, they are more volatile than domestic savings and more sensitive to shifts in market sentiment and in macro-economic policies, to a degree that has proven, in the Asian financial crisis of 1997-98, to be brutally destabilising. Given also the existence of some forbearance, in terms of, for example, the disclosure of activities and the maintenance of concentrated positions, in the interest of sustaining the presence of foreign financial intermediaries and foreign savings, there is a much greater likelihood of market overshooting. This may at times be so serious as to lead to general panic, as herd instinct, following the sometimes deliberately transparent actions of the renowned market leaders, takes hold. This then results in problems of systemic dimensions, threatening financial meltdown and serious disruptions to financial intermediation and economic activities. Furthermore, the revolution in information technology, working through financial innovation, has greatly increased the potency of international capital, particularly portfolio capital. There is no doubt that the dynamics of international finance have become much more demanding than before, for an emerging market in Asia, and elsewhere, that embraces financial openness. This is so in respect of all areas of macro-economic policies, including exchange rates, which I shall also address later, and all aspects of financial market structure. Domestic macro-economic problems, considered to be benign one day, all of a sudden can become malignant the next, triggered possibly by some strange events, and then sharp, destabilising reversals of capital flow ensue.

The new dynamics, of course, present difficult challenges for the maintenance of **monetary and financial stability**, and this is the **fifth** characteristic of Asian finance worthy of note. The dilemma between financial openness and the maintenance of monetary and financial stability is a real one, and a harsh one under globalisation, particularly for those who are less well endowed. Here I am specifically referring to those with financial markets that are small relative to the amount of international portfolio capital that can be mobilised by foreign investors, and those acting for them, but big enough to whet their appetite for profit. Arguably, the market discipline imposed on macro-economic policies of emerging markets may de facto be more stringent than those imposed on developed markets. Indeed, what is acknowledged by many as an unsustainable, large current account deficit has been sustained in the United States for some time now, no doubt for a lot longer than if one of equivalent size relative to GDP were run by an emerging market.

To be sure, there is consensus on the need for greater macro-economic discipline, robust institutions and market structures, as a defence against monetary and financial instability. There has been much progress, for example, on improving corporate governance, and I do not wish to belittle the serious efforts made at this important micro level, through the promotion, and the interaction, of individual, regulatory and market disciplines. There is also much greater discipline in pursuing prudent macro-economic policies, to the extent of attracting criticisms of excessive conservatism, particularly in respect of the running of substantial current account surpluses and the accumulation of large foreign reserves. I am sure these independent efforts of individual jurisdictions, reflecting their different pre-occupations, arising from different domestic circumstances, will, in the fullness of time, ease their tasks in the maintenance of monetary and financial stability. But the questions that should be asked are whether they are sufficient; and if not, what is. These are issues that have been occupying our minds post-Asian financial crisis, for I certainly do not wish, in the case of Hong Kong, to mobilise once again, in whatever other form or guise, in the type of high-profile intervention in the stock market we organised in 1998. But there is, as yet, no regional consensus on the need for a long-term solution and what it might possibly be.

Meanwhile, it is a fact that there has recently been a discreet drift, or at least temporary diversions, in the smaller emerging markets of Asia away from financial openness. They seem to have become more ready than before to regulate the outflow and inflow of funds, through a variety of formal or informal measures. The measures fall into two categories and are applied, where considered appropriate, selectively, targeting a specific group of market participants, for example non-residents, or activities of a specific purpose, such as those considered speculative. The first of these limits the convertibility of the domestic currency, in either direction, and the second limits the ability of banks to expand their assets or liabilities denominated in the domestic currency. So far these have proven to be helpful in maintaining monetary and financial stability after the crisis of 1997-98, and, most important, have not undermined the flow of foreign direct investments. Perhaps this will become the new paradigm approach to monetary and financial stability in Asia, but elsewhere I have chosen to call this a "band aid" approach. Coming from Hong Kong, the freest economy in the world, where by law we are not allowed to impose any foreign exchange control policies and our currency must be freely convertible, I am reluctant to accept ad hoc limitations to financial openness. But I can quite understand the plight of other emerging markets in Asia. When the undesirable elements of international finance assume a predatory character and look us fiercely in the eye there is simply a need for self-defence, and temporary or discreet changes in the rules of the game are at times effective.

Let me turn to the **sixth** characteristic of Asian finance that I wish to draw your attention to, and this concerns **exchange rate policy**. You are, no doubt, aware of the fact that the exchange rates of currencies in Asia have become more flexible, as an outcome of the financial crisis of 1997-98. Whether or not this is a desirable outcome remains to be seen, although my view probably represents the exception rather than the mainstream opinion. I say this not for the purpose of justifying the maintenance of a fixed exchange rate for the Hong Kong dollar. I shouldn't have to. The fixed exchange rate has served Hong Kong very well and, with currency board arrangements and a very flexible economy, I do not see any insurmountable difficulty in sustaining it. And I recognise the theoretical attraction of having an additional degree of freedom in economic adjustment. In practice, however, there must be doubt about whether, in view of the possibility of severe exchange rate volatility and overshooting, this is a luxury that all economies can afford. There is also the question of whether the relationship between the current account balance and the exchange rate is always the same across different economies so that exchange rate adjustments are a panacea for correcting external imbalances. Regrettably these questions are simply not asked, or, if asked, they are drowned by political noises that appear to be made on the basis of narrow, political concern over bilateral, rather than multilateral, trade imbalances.

In any case, flexible exchange rates for many currencies in Asia does not necessarily mean exchange rates determined freely by the market, as proponents would have it. As it turns out, more flexible exchange rates in Asia have meant exchange rates being determined in a flexible manner by the authorities, through intervention, controls and restrictions, at levels that are considered in their best interests. And their best interests, whatever they are, seem for the time being to be manifested in the substantial accumulation of foreign reserves. Perhaps reserve accumulation is the objective. And I can understand why, if this is the case. The comfort of substantial ammunition for coping with the recurrence of financial turmoil has become essential for emerging markets in Asia. But exchange rate and other supporting policies that promote the accumulation of foreign reserves, intentional or otherwise, are questionable in terms of their sustainability, just as we all question the sustainability of the current global imbalance, or rather, the sustainability of the US external imbalance. They are, arguably, the two sides of the same problem.

From whichever side you are looking at it, a problem that is considered unsustainable will, of course, be corrected, sooner or later, and the questions we all would like to have answers to are how, and how violent or benign the inevitable market adjustment might be. I am afraid I do not have answers to these questions. But I just would like to point out, in this connection, that the style of management of foreign reserves, when the exchange rate of the domestic currency is flexible, is likely to be more proactive than is otherwise the case, in terms of for example currency allocation. Managers of foreign reserves are ultimately held accountable to the people they serve, and the amounts, as I pointed out at the beginning of this survey on Asian finance, are getting to be very large indeed. They are, possibly, large enough to make a difference to the dynamics of the global markets for foreign exchange and for major classes of financial instruments, and enough to make a lot of people with the relevant responsibilities feel uneasy.

Asian monetary co-operation

Indeed, this survey, focusing on six characteristics of Asian finance, represents, to me at least, a rather unhappy state of affairs. Asian finance is in a fragmented state, understandably though, given the many currency jurisdictions present, each adhering to the Asian tradition of minding one's own business. To be sure, the desire to pursue and maintain financial openness, in view of the potential and demonstrated benefits to growth and development, is still strong. But many have become weary, worried, cautious or shocked to varying degrees by the experience of financial globalisation that came with financial openness and intensified by the revolution in information technology. From a regional perspective, it does seem that Asian finance is organised in such a way that, instead of harnessing its financial strength to its advantage, it finds itself in a position of vulnerability to financial instability. It is with this sentiment that I turn now to the subject of Asian monetary co-operation.

Some would argue that the fragmented state of Asian finance, to the extent that it is an issue, is merely a reflection of the diversity of Asia, in terms of history, geography, culture, stages of economic development, size distribution, political structure, degree of economic and financial openness, etc. Indeed, Asia is a very heterogeneous group of economies. In the richest economy, per capita GDP, if this is an appropriate measure of richness, is about 180 times that of the poorest. By contrast, in the euro area it is only about four times. And if one assesses the emerging markets of Asia against the Maastricht criteria, one can conclude rather conveniently that Asian monetary co-operation, implying Asian Monetary union, is a non-starter. This is even more so considering the virtual absence of labour mobility and the existence of large patches of different degrees of restrictions in capital mobility.

But the important thing to realise is that the degree of trade integration, and therefore the degree of interdependence among Asian economies, is very high. About half of total trade in Asia is intra-regional. This is more or less the same as the proportion of Europe's intra-regional trade to total trade when the Treaty of Rome was signed. And intra-regional trade within Asia has been growing rapidly - a trend that is likely to continue in the foreseeable future. There is considerable vertical integration of the production process in Asia, driven by foreign direct investment flows within Asia and outsourcing of the process to the area possessing the comparative advantage. China is increasingly serving as the manufacturing powerhouse of Asian exports, while other Asian economies supply the raw materials, semi-manufactured goods and machinery. Admittedly, the larger part of intra-regional trade in Asia, 56% according to our internal estimates[2], is related to processing trade, some of which is to meet demand from the developed economies in North America and Europe. But this reliance on the demand from the developed markets is likely to decrease over time, as rapid economic growth within the region promises to provide a sustainable impetus, helped by the dismantling of trade barriers and the establishment of free trade agreements within the region.

This high and increasing degree of trade integration and regional interdependence has clearly not been matched by a corresponding degree of financial and monetary integration. It is, of course, arguable whether there is a need for such correlation or causal relationship, and if so, whether the market can be relied upon to produce the optimum arrangements in due course without official sector involvement. My view is that monetary integration is desirable and, given the role of the state in the monetary system, cannot be achieved by market forces. I hope that, looking at the matter from a European perspective, you agree with me. The fact of the matter is that diversity or fragmentation leads to individual vulnerability, and interdependence is synonymous with contagion, particularly financial contagion. This is notwithstanding the low degree of financial integration and varying degrees of financial openness. The ingenuity of the financial community can be relied upon to establish financial linkages, where there is none officially allowed, through which what appears to be unmanageable financial risks can be managed and, consequently, financial contagion can be readily transmitted. The emerging markets of Asia provide fertile ground for financial innovation. For example, we hear often that the Hong Kong financial markets provide a perfect hedge, or more modestly, a proxy hedge, for risks in the Mainland of China or the region. There is an element of truth in this. After all, this is one of the roles of an international financial centre. But it does mean that, in Asia, the dynamics of financial contagion can be quite complex. For example, financial crises do not necessarily erupt and manifest themselves at source - somebody sneezes and others get pneumonia.

So, it is only prudent that Asian monetary co-operation should be on the agenda of discussions on Asian finance, and I have been urging for greater co-operation for some time. I am therefore glad that there has been increasing attention given to the subject in recent years. But, in terms of actual co-operative initiatives, progress has been slow and the scope rather narrow. To be fair, there is consensus on the need for diversification of financial intermediation channels, for enhancing efficiency and financial stability, and this consensus has been manifested in co-operative efforts to develop the bond markets in Asia. There are three clusters of initiatives:

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2 "What is driving Asian exports?", HKMA, August 2003.

- The first is the APEC Initiative on the Development of Securitisation and Credit Guarantee Markets, which is spearheaded by three APEC member economies, namely, Hong Kong, Thailand and Korea, and sponsored by the World Bank;
- The second is the Asian Bond Market Initiative (ABMI) of the ASEAN+3 forum; and
- The third is the Asian Bond Fund initiative of EMEAP, comprising eleven central banks in the region, which has successfully launched ABF1, denominated in US dollars and has been working hard on ABF2 to be denominated in domestic currencies.

There is inevitably competition among these forums, some overlap on the issues being addressed and use of different strategies. In Asia there is no political or institutional framework comparable to the one in Europe for taking a more focussed approach and for co-ordinating efforts. But all the initiatives have the common aim of addressing the structural impediments to the development of bond markets, including for example harmonising standards and practices, and creating the necessary regional financial infrastructure to facilitate this much needed development. There is momentum built up and I am hopeful that we should see significant progress made in the years to come.

But I think the long-term solution to the problems of Asian finance lies in co-operation in respect of currency arrangements. If, as I argued, financial market fragmentation in Asia leads to individual vulnerability to financial instability, and through contagion regional vulnerability, then one intuitive solution is to integrate the fragmented markets through some form of monetary union. Admittedly, a monetary union does not remove all sources of financial instability in the region, which could arise from volatile business cycles, for example, boom and bust induced by inappropriate policies, and moral hazard induced, for example, by implicit government-guarantee of bad credit. But it does take care of financial instability associated with volatile capital flows and the associated large swings in real exchange rates. But, as of now, this is still not an item on the agenda of Asian monetary co-operation, at least in any official forum that I am aware of. As far as I can recall, there have only been some limited efforts of mutual assistance:

- The first is the collection of EMEAP bilateral swap facilities that provide US dollar liquidity secured against US Treasury securities that were put together in November 1995, which have not been used;
- The second is the idea originating from Japan in 1997 for an Asian Monetary Fund, which did not go beyond being an idea; and
- The third is the collection of ASEAN+3 bilateral swap arrangements (between the US dollar and domestic currencies) under the Chiang Mai Initiative, which involve the assumption of credit risks.

There is, in fact, continued scepticism towards any form of monetary union in Asia. Perhaps this is because the structure of the European model - the only successful example - requires convergence as a pre-requisite. As I mentioned earlier, in many respects, Asia is much more heterogeneous than Europe, so that convergence realistically will take time, even if there is agreement to converge. But my view is that since it takes so long - 50 years in the case of Europe - we'd better start at least the thinking process early, hadn't we? And we can also afford to be imaginative if it is something that aged people like us won't see in our lifetime. The flexibility of Asia is well recognised. We only have to look at how individual economies bounced back after the Asian financial crisis. Perhaps they are flexible enough for convergence to be forced onto them by just plunging in. And to ease the way, how about an interim arrangement that provides intra-regional exchange rate stability through hard pegs to a synthetic, floating Asian currency unit? Perhaps the International Centre for Banking and Monetary Studies has wise observations to offer. I myself have found it difficult and a little frustrating to go beyond articulating the problems and the unsustainable nature of Asian finance, raising interests and asking questions.

China

Let me now turn to China. I notice that there is considerable interest in the international financial community in the banking and monetary developments there. This is understandable, given the sheer size of China and, particularly for Asia, where China is now a most important component of an economically integrated region. As I argued earlier, interdependence is synonymous with the transmission of financial shocks, particularly financial contagion. It is therefore in the interests of others in Asia to understand China, where the dilemma between pursuing financial openness and the maintenance of financial stability is a most difficult one to resolve. The ability of China to get it right in meeting the many challenges of this task has serious implications for all. And, as I also argued earlier, the dynamics of Asian finance are such that financial crises do not necessarily occur or be most serious at source. The task confronting China is, arguably, a task for others in Asia as well. Whether one adopts the inward-looking attitude of trying to limit possible contagion to the domestic market, or becomes more proactive in contributing, through appropriate assistance and co-operation, to the effective performance of that task in China, or both, is a matter of choice for individual jurisdictions. For Hong Kong Special Administrative Region, which is part of China but operates different banking and monetary systems under the arrangement of “One Country, Two Systems”, we are too close to the Mainland to afford to be inward looking. Indeed, from the business perspective and being the international financial centre of China, we must position ourselves for and try and make the best of the opportunities that come with the inevitable process of financial liberalisation of the Mainland. So we spend much of our time and attention on monetary and financial issues on the Mainland. But I must still confess an occasional inability to understand exactly what goes on there.

With a high savings rate, rapid economic growth, and the attraction of an emerging market of mammoth dimensions and ample opportunities, the Mainland of China can afford to adopt a cautious approach to financial liberalisation. Even with continuing, tight capital controls, there is no lack of foreign direct investments. The size and strength of the economic magnet of Mainland China are such that it has become, for a number of economies in the region, one of the largest trading partner and destination for outward direct investment. Foreign portfolio investments into the Mainland of China, to the extent that these opportunities are available, for example, in the stock market of Hong Kong, are also in great demand. With an abundance of domestic savings (the savings rate is around 30% to 40%), the emphasis is on financial sector reform, to enhance the efficiency of domestic financial intermediation, in order to sustain growth and development, rather than to attract an inflow of foreign savings. And the domestic financial markets in the Mainland are big enough to attract many of the leading names in finance to establish a presence, without having to resort to offering business opportunities in international financial intermediation through premature capital account liberalisation.

The strategy of financial sector development, as in the case of the overall development strategy of the Mainland of China, is, to the extent that I can observe, one characterised by gradualism, as against “big bang”. There is strong emphasis on achieving a balance among reform, development and stability, which also encompasses the theory of path dependency propounded by Douglas North, the Nobel Laureate in 1993. This was more vividly articulated by the late Deng Xiaoping, I am sure independently without consulting Douglas North, as “crossing the river by feeling the stones”. More recently, Governor Zhou of the People’s Bank of China has encapsulated these theories - gradualism and path dependency - in an interesting, academic exposition, in one of our HKMA lectures in Hong Kong, as the concept of ensuring “Pareto Improvement” in achieving “Pareto Optimality”. This concept is best described through an analogy of a hiker choosing a path (involving Pareto Improvement) to the top of the mountain (the point of Pareto Optimality). The shortest way is of course to go in a straight line. But in a three dimensional world this assumes that one can fly, if the slope of the mountain is concave, or move through earth, if the slope of the mountain is convex. The practical way is to ensure that you are moving up each step you take, in other words making improvements, regardless of whether you are following a spiral or a zigzag path, or whether you can see the top, or the point where allocation of resources is optimal.

Appreciation of this concept is essential in understanding developments in the Mainland of China, including those on the financial front. The preponderance of the banking sector in domestic financial intermediation calls for great care in the reform of the banking system, in a manner that does not undermine public confidence in the banking system. This means the continuation of state ownership and financial support, and, for the time being, de facto limited competition from foreign banks, notwithstanding WTO commitments. On the other hand, there is a strong desire to modernise management and move towards the observation of international standards, to facilitate the ongoing commercialisation and the eventual privatisation of the banks. This is a delicate process, particularly when, in terms of the prudential numbers, the banking system is clearly weak and, with the greater freedom of information that comes with modern information technology, depositors’ faith will not remain unwavering forever. The drive for diversification in financial intermediation, evidenced in genuine efforts to develop the debt and equity markets, will further divert funds away from the banking system.

Meanwhile, even with a clear intention to do so, the practice of lending, and the pricing of lending, in accordance with state policy and not the credit worthiness of the borrower takes time to get rid of. Although it does not take long for the credit officer to learn to look at the balance sheet and the profit and loss account of the borrower, the security of the job requires an unspoken recognition of the authority of those in a position of power in the government bureaucracy. A further complication is the fact that commercial bankers are part of the government bureaucracy. In such a system, it is difficult for the bureaucratic position of the individual to be aligned with the commercial interest of the bank, which is to make profit. There is an interesting description of the stance of such an individual: where you stand (on an issue) depends on where you sit (in the bureaucracy). Consequently, it will take some time before the process of credit allocation becomes entirely market-based and the banks subject to the market disciplines that we are familiar with. One implication of this is that the high NPL and low capital adequacy ratios will continue to be a feature, with ebbs and flows, as capital injections get rid of the stock of NPL while the flow of NPL continues, but hopefully at a reduced pace as corporate governance improves. Professionalism cannot be acquired overnight. There is also the need of a proper, market based incentive system, in terms of both monetary and career rewards, for promoting professionalism. This applies not only to employment in the banks, or just in the financial system. It is a fundamental issue concerning the labour market as a whole, which is still characterised by wage levels still being predominantly centrally determined, but labour market reform is obviously out of the scope of this speech. I just want to say that, as in market reform generally, labour market reform takes time and that in the interest of social stability, gradualism is once again the key.

Indeed, in the long march towards a market economy, there will be conflicts or anomalies that require pragmatism in resolving and doing things by trial and error. One feature in this process is the continuing use of executive authority or administrative measures to effect the necessary macro-economic adjustments rather than the use of financial market instruments. This is unavoidable before the markets have developed to a stage in which they can be relied upon to produce the desired results. The transmission mechanism working through inefficient financial markets must be of doubtful effectiveness. By contrast, although administrative measures are clumsy and authoritarian, they are quick in producing results. The administrative measures introduced in late April of slowing project approvals, reducing land supply, centralising lending authorities and reducing bank credit to specific activities have worked reasonably well. The growth of fixed asset investment, broad money and bank credit slowed down quickly in the second quarter of the year, although not without causing serious concern about the possibility of a hard landing. To be sure, the bluntness of administrative measures did lead to inconveniences and perhaps casualties among innocent parties, as cash flow, for a time, dried up for almost everybody rather than the targeted activities. But by and large the measures are working. And about two weeks ago these were interestingly buttressed by increasing interest rates and further liberalisation in the determination of deposits and lending rates. This is another encouraging development in market reform.

Let me, lastly, say a few words about the RMB exchange rate. I do not have the privilege of inside knowledge on the subject. The fact of the matter is that there is only a small current account surplus. It is true that there has been large capital inflow lately, as manifested in the rapid build-up of foreign reserves. This was predominantly the result of international political pressures for a more flexible exchange rate. As such it would be a temporary phenomenon, although, with interest rates of the RMB higher than those of the US dollar, there is a significant cost incurred in sterilisation. In so far as the maintenance of a fixed exchange rate is concerned, this is currently not a problem, particularly with capital controls. But there is scope and attraction for experimenting with greater flexibility in the fullness of time and that is indeed the declared intention of the Mainland authorities. However, with ongoing macro-economic adjustment, I doubt if this is the right time for experimenting.

Conclusion

In this speech I have surveyed the characteristics of Asian finance and concluded that it is, at least to me, in a rather unhappy, and possibly unsustainable, state. We have to seek a long-term solution through Asian monetary co-operation, or continue to be vulnerable to financial instability and defend ourselves through ad hoc retreats from financial openness. The Mainland of China, itself facing a most difficult task of financial reform, is an increasingly important factor in all this, as trade and economic integration of the region continues apace. Thank you.